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Social Clubs and the Profit Motive Test: Allowability of Excess Deductions Against Investment Income

ALAN BANSPACH*

I. INTRODUCTION

Social clubs which qualify for tax exempt treatment under the Internal Revenue Code (IRC or the Code) section 501(c)(7) form a significant percentage of all tax exempt organizations in the country.¹ Examples include country clubs,² equestrian clubs,³ flying clubs,⁴ and the like. Such organizations are generally exempt from taxation on income derived from dues, fees, or other amounts paid by its members; however, all other club income obtained from any other source, including investment income, is subject to tax as unrelated business taxable income.⁵ Against this taxable income, a social club is permitted to deduct an aggregate of its allowable expenses and is not required to match each item of expense to the corresponding item of income.⁶ This Article focuses on the requirements for deductibility of such expenses, and more particularly whether a social club may net excess expenses attributable to an income generating activity against income from passive investments.

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1. As of 1987, there were 56,216 social and recreational clubs qualifying for tax exempt treatment under Internal Revenue Code (IRC) section 501(c)(7), comprising just under 10% of the total number of tax exempt organizations. Treasury Department Studies and Proposals (H. Ways and Means Comm., June 22, 1987), pt. 1, at 55.

2. *See* Tamarisk Country Club v. Commissioner, 84 T.C. 756 (1985).

3. *See* Barstow Rodeo & Riding Club, Inc., 12 T.C.M. (CCH) 1351 (1953).

4. Rev. Rul. 74-30, 1974-1 C.B. 137.

5. I.R.C. § 512(a)(3)(A) (1989).

6. *See id.*

II. HISTORY

The tax on unrelated business income of tax exempt organizations was first enacted in 1950.⁷ Prior to that time, the law was unsettled as to the limits on tax exempt organizations earning income from unrelated business activities.⁸ As time progressed, it became clear that some tax exempt organizations were engaging in businesses unrelated to their exempt purposes.⁹ These organizations were perceived to be enjoying substantial competitive advantages vis-a-vis their taxpaying business rivals by using their tax exempt status.¹⁰

As a result of the perception of widespread unfair competition, corrective legislation was included in the Revenue Act of 1950. This legislation forms the basis for the present sections 511 through 513 of the IRC which provide a tax on the unrelated trade or business income of certain otherwise tax exempt organizations.¹¹ However, certain organizations such as social clubs were excluded from the original tax and continued to be excluded until the Tax Reform Act of 1969.¹² The 1969 Act extended the unrelated business taxable income concept to these organizations. Further, the Act included a provision to tax certain investment income of social clubs.¹³ This latter provision was a reaction to the burgeoning concern among many members of Congress that such organizations were using untaxed income from outside sources such as passive investments, to provide pleasure or recreation to their membership.¹⁴

7. H.R. 8920, 81st Cong., 2d Sess. (1950).

8. One early limitation on tax exempt organizations conducting such business activities was the "destination of income" test, established by the United States Supreme Court in *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924). The "destination of income" test provides that it is the destination and not the source of the income which is the ultimate test of the right of tax exemption for the organization. *Id.* at 581. This test was not easy to apply and led to much confusion among the federal circuits. The wording of the *Sagrada Orden* opinion left room for more than one interpretation and created some question as to its intended breadth. *See, e.g.*, *Samuel Friedland Found. v. United States*, 144 F. Supp. 74 (D.N.J. 1956) (where the court pointed out that the *Sagrada Orden* court also spoke of the possibility that engaging in business pursuits in competition with others might bring about the denial of the exemption for that tax exempt organization); *People's Educational Camp Soc'y, Inc. v. Commissioner*, 331 F.2d 923 (2d Cir.), *cert. denied*, 379 U.S. 839 (1964).

9. For illustrations of the extent to which tax exempt organizations were unfairly competing with taxed businesses, see *Revenue Revisions of 1950: Hearings Before the Comm. on Finance United States Senate on H.R. 8920 An Act to Reduce Excise Taxes and For Other Purposes*, 81st Cong., 2nd Sess. 374, 846 (1950).

10. *Id.*

11. Revenue Act of 1950, Sept. 23, 1950, ch. 994, 64 Stat. 906.

12. HOUSE WAYS AND MEANS COMM. AND SENATE FINANCE COMM., TAX REFORM STUDIES AND PROPOSALS, 94th Cong., 1st Sess., pt. 3, at 27 (1969) [hereinafter TAX REFORM STUDIES]. Other organizations which were included under the unrelated business income tax at that time were churches and fraternal beneficiary societies. *Id.*

13. I.R.C. § 512(a)(3)(A) (1989).

14. *See Rolling Rock Club v. United States*, 785 F.2d 93 (3d Cir. 1986); *see also* TAX REFORM STUDIES, *supra* note 12, at 316-17.

III. TAXATION OF IRC SECTION 501(c)(7) ORGANIZATIONS

Social clubs organize and operate exclusively for pleasure, recreation, or other nonprofit purposes of like character and are generally exempt from taxation under the Code so long as no part of the club's net earnings inure to the benefit of any private shareholder or member.¹⁵ The purpose of this exemption is to allow individuals to join together for recreation or pleasure on a mutual basis without incurring greater tax liability than if they had acted on an individual basis.¹⁶ For example, if an individual purchased a horse for personal pleasure and spent sums maintaining the horse, those sums would clearly not be taxable as income. If, however, fifty individuals decided to pool their funds to purchase several horses, then charge the membership a fee per ride to cover the maintenance costs, such fees would be considered income¹⁷ in the absence of the section 501(c)(7) tax exemption.¹⁸

The exemption provided to social clubs under section 501(c)(7) extends only to "exempt function" income which generally includes income derived directly from the membership and amounts set aside for charitable and similar purposes.¹⁹ All other income, including investment income, will be subject to tax as unrelated business taxable income.²⁰ In order to be exempt from tax, the "exempt function" income must meet a two part test: (1) the income must be generated from providing "exempt function" facilities, and (2) the income must be received from the membership.²¹ For example, where a country club qualifying for section 501(c)(7) treatment receives membership dues, food concession income, and greens fees from both members and nonmembers as well as interest income received from a member paying back a loan to the country club, the nonmember

15. I.R.C. § 501(c)(7) (1989).

16. See S. REP. NO. 152, 91st Cong., 1st Sess. 71 (1969); H.R. REP. NO. 413, 91st Cong., 1st Sess., pt. 1, at 47 (1969).

17. See generally I.R.C. § 61 (1989).

18. Should a social club fail to qualify for exemption under section 501(c)(7), section 277 will generally apply. Under section 277, deductions attributable to furnishing services, insurance, goods, or other items to the members will be allowed only to the extent of income derived during the year from members or transactions with members. Any excess deductions will be carried over to succeeding taxable years. Thus, under section 277, investment income or nonmember receipts may not be used to defray all or a part of the cost of providing services to members and thereby escape tax. I.R.C. § 277 (1989).

19. I.R.C. § 512(a)(3)(B) (1989).

20. See *id.*

21. TAX REFORM STUDIES, *supra* note 12, at 324.

food concession and greens fees income as well as the loan proceeds²² would not qualify as "exempt function" income and thus would be subject to tax on unrelated business income.²³

The test for taxation of income and allowance of deductions for a section 501(c)(7) organization is a special rule found in section 512(a)(3)(A).²⁴ Section 512(a)(3)(A) generally provides that a section 501(c)(7) organization's taxable income is equal to its gross income excluding "exempt function" income minus allowable deductions directly connected with the production of such gross income, again excluding the "exempt function" income.²⁵ Assume a club incurs food concession income from members and nonmembers, greens fees from members and nonmembers, and interest income. In addition, assume the club incurs expenses in the form of nonmember food preparation costs, employee salaries, utilities, depreciation on the club premises, and expenses relating to the interest income. As stated above, the nonmember concession and green fees income, along with the interest income, would not qualify for "exempt function" income treatment and, thus, would be included in the section 512(a)(3)(A) equation. Assuming the above stated expenses are all otherwise allowable, only those expenses directly connected with the production of gross income (excluding "exempt function" income) would go into the section 512(a)(3)(A) equation. Therefore, the interest expense and the food preparation costs would be allowed as deductions against the organization's taxable income as they are both directly connected with the production of nonexempt function gross income. In addition, that portion of the expenses for salaries, utilities, and depreciation which are allocable to nonmember food preparation and other nonmember service income will also be included. Those expenses allocable to providing "exempt function" services to members would not be included in the equation. The resulting figure constitutes unrelated business taxable income and is therefore subject to tax.

In the above example, it was assumed that the listed expenses were otherwise allowable under the Code.²⁶ Whether or not such expenses are otherwise allowable is a hotly debated topic which is the subject of a substantial amount of recent litigation.²⁷ In this regard,

22. Although these amounts would meet the second part of the two part test since they are received from the membership, they would not qualify under the first part since they are not received in exchange for "exempt function" facilities. *Id.*

23. I.R.C. § 512(a)(3)(A) (1989).

24. *See id.*

25. *Id.*

26. Section 501(a)(3)(A) requires that for deductions to be allowable under section 501(c)(7), they must also be allowable under some other provision of chapter one of the Code.

27. *See, e.g., North Ridge Country Club v. Commissioner*, 89 T.C. 563, 579

the primary issues addressed by the courts are whether a social club may net excess expenses attributable to an income generating activity against income from passive investments, and more particularly, whether social clubs must show a profit motivation as to the income generating activities for excess deductions to be allowable against other income.²⁸

IV. ALLOWABILITY OF EXCESS DEDUCTIONS AGAINST INTEREST INCOME

A. Revenue Ruling 81-69

The issue of excess deductions for multiple nonexempt activities was first addressed by the Internal Revenue Service (Service) in Revenue Ruling 81-69.²⁹ That ruling involved a social club which had unrelated business taxable income from both investment income and from sales of food and beverages to nonmembers.³⁰ The club's sales of food and beverages to nonmembers over the years were at prices which were consistently insufficient to recover the costs of such sales, and there were indications that such sales would continue to result in losses for the club.³¹

Applying section 162 of the Code,³² the Service held that the food and beverage sales did not constitute ordinary and necessary expenses incurred in carrying on a trade or business.³³ The Service noted that one requirement for a trade or business for the purposes of a section 162 deduction is a profit motivation, whether or not the activity is being conducted by a tax exempt organization or a profit making organization.³⁴ The Service held there was no profit motive

(1987), *rev'd*, 877 F.2d 750 (9th Cir. 1989); *Brook, Inc. v. Commissioner*, 799 F.2d 833, 838 (2d Cir. 1986); *Cleveland Athletic Club v. United States*, 799 F.2d 1160, 1166 (6th Cir. 1985); Rev. Rul. 81-69, 1981-1 C.B. 351.

28. *See supra* note 27.

29. Rev. Rul. 81-69, 1981-1 C.B. 351.

30. *Id.*

31. *Id.*

32. Note that section 512(a)(3) of the Code provides that unrelated business taxable income is determined by subtracting from the gross income, the deductions *allowed by chapter one of the Code*. The deduction section most appropriate under these facts is section 162 since a taxpayer engaged in an activity which is not a trade or business may generally take deductions only up to the amount of the income generated by the activity under either section 212 or section 183.

33. Rev. Rul. 81-69, 1981-1 C.B. 351.

34. *Id.* Note, however, that for this proposition, the Service cites *Iowa State Univ. of Science and Technology v. United States*, 500 F.2d 508 (Ct. Cl. 1974), which was a section 501(c)(3) tax exempt organization and thus was governed by section 512(a)(1), not section 512(a)(3)(A).

in this case because the prices were not sufficient to recover costs.³⁵ Thus, for purposes of computing unrelated business taxable income, the social club was barred from deducting from its net investment income or its losses from the food sales to nonmembers.³⁶

B. Cleveland Athletic Club v. United States

The position of the Service as espoused in Revenue Ruling 81-69, was expressly rejected by the Sixth Circuit Court of Appeals in *Cleveland Athletic Club v. United States*.³⁷ *Cleveland Athletic* involved a social club which derived unrelated business income from two sources: investments and nonmember sales of food and beverages on the club premises. With regard to the sales of food and beverages to nonmembers, the club incurred what the court described as "direct expenses" consisting of "[the] cost of goods sold, salaries, and other directly related expenses"³⁸ The club also incurred "indirect expenses" consisting of "items such as rent, insurance, and depreciation."³⁹ The court indicated that these latter expenses were "fixed expenses" which would have been incurred whether or not the club served nonmembers.⁴⁰ During the years at issue, although the gross receipts from nonmember sales exceeded the direct expenses, a net loss resulted when the indirect expenses were allocated to the nonmember sales.⁴¹

The Commissioner, relying on Revenue Ruling 81-69, argued un-

35. Rev. Rul. 81-69, 1981-1 C.B. 351.

36. *Id.*

37. 779 F.2d 1160 (6th Cir. 1985).

38. *Id.* at 1161.

39. *Id.*

40. *Id.* In order to determine the amount properly deductible from unrelated business income, the fixed expenses were allocated, without objection from the government, based on the ratio that nonmember sales bore to total sales. *Id.*

41. *Id.* The unrelated business taxable income for the Cleveland Athletic Club for years in question is broken down into gross income and expenses as follows:

	1975		1976		1977		1978	
	Inv*	F/B**	Inv	F/B	Inv	F/B	Inv	F/B
Gross Income	34.3***	184.5	35.9	117.2	36.9	246.2	42.4	135.8
Direct Costs	-0-	108.6	-0-	80.4	-0-	166.7	-0-	94.7
Gross Profit	34.3	75.9	35.9	36.8	36.9	79.5	42.4	41.2
Indirect Expenses	-0-	120.2	-0-	68.5	-0-	131.4	-0-	78.5
Net Income	34.3	(44.3)	35.9	(31.8)	36.9	(51.9)	42.4	(37.3)
Total								
Gain/Loss	(10.0)			4.1		(15.0)		5.0

* Investment income

** Income from sales of food and beverages to non-members

*** Thousands of dollars

successfully "that each unrelated business activity must be considered separately and not aggregated" and that each activity must meet the requirements of section 162(a) of the Code in order for that activity's deductions to be allowable against other unrelated business activities.⁴² The Commissioner noted that one of the requirements of section 162 is that the activity for which a deduction is sought is undertaken with a profit motive.⁴³ The Commissioner argued that no such motive was present in this case as evidenced by the losses present in all of the years in question.⁴⁴

The court first considered the definition of "unrelated business taxable income" as applied to social clubs found in section 512(a)(3)(A).⁴⁵ It noted that this definition was markedly different from the general rule which applies to charities and other tax exempt organizations.⁴⁶ The court indicated that the "salient difference" between the two sections is that section 513(a)(3), which pertains to social clubs,

begins by computing gross income in general, excepts exempt function income and then subtracts deductions connected with the *production of gross income*. The general section (Sec. 512(a)(1)) begins with gross income from unrelated *trade or business only*, and subtracts deductions connected with

Id.

42. *Id.* at 1162-63.

43. *Id.*

44. *Id.* at 1164. Note, however, that in Revenue Ruling 81-69, the Service states that the prices were "insufficient to recover the costs" of providing food and beverages to nonmembers. It is not clear from this statement of fact whether the prices were sufficient to recover the direct costs as was the case in *Cleveland Athletic*. Rev. Rul. 81-69, 1981-1 C.B. 351, 352.

45. *Cleveland Athletic*, 779 F.2d at 1165.

46. *Id.* The general definition of "unrelated business taxable income" is found in section 512(a)(1) of the Code, which provides as follows:

(1) GENERAL RULE.—Except as otherwise provided in this subsection, the term "unrelated business taxable income" means the gross income derived by any organization from any unrelated trade or business (as defined in section 513) regularly carried on by it, less the deductions allowed by this chapter which are directly connected with the carrying on of such trade or business, both computed with the modifications provided in subsection (b).

I.R.C. § 512(a)(1) (1989). The definition of "unrelated business taxable income" for purposes of section 501(c)(7) organizations appears in section 512(a)(3)(A), which provides:

(A) GENERAL RULE.—In the case of an organization described in section 501(c)(7) or (9), the term "unrelated business taxable income" means the gross income (excluding any exempt function income), less the deductions allowed by this chapter which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modifications provided in paragraphs (6), (10), (11) and (12) of subsection (b)

I.R.C. § 512(a)(3)(A) (1989).

the carrying on of such *trade or business*.⁴⁷

The Sixth Circuit determined that this difference was intentional on the part of the legislature, and that as a result, the trade or business requirement of section 162(a), and thus the profit motive test, was not required for deductibility of expenses of unrelated business activities of social clubs.⁴⁸ Instead, the court indicated that deductions will be allowable for purposes of the section 512(a)(3)(A) equation so long as they were “ordinary and necessary to the production of income” and where the activity involved had a “basic purpose of economic gain.”⁴⁹ Although it is not entirely clear from the language of the opinion, it appears the court intended to establish a new generic standard of deductibility of expenses for section 501(c)(7) organizations.⁵⁰

In support of this generic standard, the court cited the Department of the Treasury’s *Tax Reform Studies and Proposals*⁵¹ which states “that all income other than exempt function income would be included in gross income regardless of whether the activity generating the gross income met the requirements of a ‘trade or business regularly carried on.’”⁵² The court also cited the publication for the proposition that “to remain consistent, ‘deductions would be allowable if directly connected with an activity generating income subject to tax, rather than only if directly connected with an unrelated trade or business regularly carried on.’”⁵³

In discussing the profit motivation issue, the court stated that it did not believe that the nonmember business activities generate a “tax profit” in order for excess deductions to be allowable.⁵⁴ Although the court never defines this term, one must presume it would describe a situation where a net taxable income would result after

47. *Cleveland Athletic*, 779 F.2d at 1165.

48. *Id.*

49. *Id.*

50. The opinion suggests that the court intended this as a generic test to be applied where nonexempt gross income is generated, whether passive investment or service providing activity. The facts of the case suggest that the economic gain test would require a showing of income beyond the direct expenses but not the indirect expenses of a particular activity.

51. TAX REFORM STUDIES, *supra* note 12.

52. *Cleveland Athletic*, 779 F.2d at 1165 (quoting TAX REFORM STUDIES, *supra* note 12, at 324).

53. *Id.* at 1166 (quoting TAX REFORM STUDIES, *supra* note 12, at 325). The court also cited Proposed Treasury Regulation § 1.512(a)-3(b)(3), now withdrawn, which required aggregation of both gross unrelated business income and deductions allowed with respect to such gross income. *Id.* Although the proposed regulations were withdrawn on January 26, 1987, the withdrawal should have little effect on the Sixth Circuit’s opinion since the court stated the proposed regulations had no legal force and effect, and were merely indicative of the intentions of the Treasury. *Id.*

54. *Id.* at 1165. See *infra* notes 90-135 and accompanying text for discussion of the tax profit issue.

subtracting both "direct" and "indirect" deductions.⁵⁵ The court further cites *Trustees of Graceland Cemetery Improvement Fund v. United States*⁵⁶ for the proposition that "the profit factor" is only significant where it is a means of distinguishing between an activity carried on in good faith as a trade or business and an activity carried on merely as a hobby.⁵⁷ The court noted that in this case the activities were clearly not carried on as a hobby.⁵⁸

C. Brook, Inc. v. Commissioner

A different approach was taken by the Second Circuit in *Brook, Inc. v. Commissioner*,⁵⁹ which involved a similar situation to the one considered by the *Cleveland Athletic* court. In *Brook*, a social club qualifying under section 501(c)(7) for tax exempt status had unrelated business taxable income consisting of investment income and food and beverage sales to nonmembers.⁶⁰ In regard to the food and beverage sales, deductions consisting of both direct expenses and properly allocable overhead costs exceeded the income received from such sales for every year of an eleven year period, including the years at issue.⁶¹ In addition, the taxpayer stipulated that it did not intend to sell food and beverages to nonmembers at prices which would exceed all costs, including overhead.⁶²

The Second Circuit held that the excess deductions from losses suffered from the taxpayer's serving of meals to nonmembers were not deductible against the social club's investment income because the taxpayer had failed to satisfy the requirements of section 162.⁶³ The court noted that in order for an activity to qualify as a "trade or business" under section 162 it is well established that the taxpayer must engage in the activity with the intention of making a profit.⁶⁴

55. This definition of tax profit is consistent with that put forth by the Tax Court in *North Ridge Country Club v. Commission*, 89 T.C. 563 (1987), *rev'd*, 877 F.2d 750 (9th Cir. 1989). See *infra* notes 104-05.

56. 515 F.2d 763 (Ct. Cl. 1975).

57. *Cleveland Athletic*, 779 F.2d at 1165. This is perhaps an unfortunate case to cite for this proposition. The *Trustees of Graceland* decision involved the issue of whether a subsidiary enterprise assumes the tax status and profit motive of its controlling parent so that it could take deductions under section 162. See *Brook, Inc. v. Commissioner*, 799 F.2d 833, 839 n.7 (2d Cir. 1986).

58. *Cleveland Athletic*, 779 F.2d at 1165.

59. 799 F.2d 833 (2d Cir. 1986).

60. *Id.* at 835.

61. *Id.*

62. *Id.*

63. *Id.* at 838.

64. *Id.*

The court noted that the taxpayer stipulated it had no profit motive and thus the profit motive test of section 162 was not satisfied.⁶⁵

The court considered, but rejected, the economic gain test advocated by the Sixth Circuit in *Cleveland Athletic*.⁶⁶ Among the court's reasons were the facts that the economic gain test is not a requirement found in any presently existing deduction section, and that section 512(a)(3)(A) specifically required a deduction to be "allowed by this chapter" in order to be deductible against gross income under 512(a)(3)(A).⁶⁷ In addition, the *Brook* court rejected the Sixth Circuit's interpretation of the meaning of the differences between the two definitions of "unrelated business taxable income" in sections 512(a)(1) and 512(a)(3)(A).⁶⁸

The *Brook* court thought that section 162 was incorporated by reference in section 512(a)(3)(A) since section 162 is the only section which would have allowed a social club to deduct excess deductions against investment income.⁶⁹ The court stated that the Sixth Circuit's economic gain test was incorrect in allowing a taxpayer to deduct expenses arising from activities which it did not engage in for profit so long as the club engaged in the activity with a basic purpose of economic gain.⁷⁰ To do so would be, in the view of the Second Circuit, to allow a taxpayer to completely bypass the requirements of section 162.⁷¹

D. Profit Motivation

Cleveland Athletic stands for the proposition that a profit motivation need not be shown for section 501(c)(7) organizations in order for excess deductions from one unrelated business activity to be allowable against interest income.⁷² Instead, the court argued in favor of a generic test whereby a social club need only show a "basic purpose of economic gain" in order for an expense to be allowable as a deduction.⁷³ To support this proposition, the Sixth Circuit cited legislative history stating that "'deductions would be allowable if directly connected with an activity generating income subject to tax, rather than only if directly connected with an unrelated trade or business regularly carried on.'"⁷⁴ Although this statement could be read

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.* at 840.

69. *Id.* at 838.

70. *Id.* at 839.

71. *Id.*

72. *Cleveland Athletic Club v. United States*, 779 F.2d 1160, 1165 (6th Cir. 1985).

73. *Id.*

74. *Id.* at 1166 (quoting TAX REFORM STUDIES, *supra* note 12, at 325).

to support this new generic standard of deductibility, it could equally be read to indicate that the purpose of section 512(a)(3)(A) was to broaden the type of deductions allowable.⁷⁵ The latter view is more consistent with the purposes for which section 512(a)(3)(A) was enacted.⁷⁶

There are several policy and statutory difficulties with the Sixth Circuit's approach in *Cleveland Athletic*. One difficulty with the court's new generic standard is its interpretation of the differences between the two definitions of "unrelated business taxable income" in sections 512(a)(1) and 512(a)(3)(A).⁷⁷ The Sixth Circuit was concerned that to apply section 162 literally to social clubs would read the "trade or business" requirement back into section 512(a)(3)(A).⁷⁸ However, the Second Circuit correctly reasoned that the difference in the two definitions was rooted in Congress's intent to tax entities such as social clubs more comprehensively than charitable and religious organizations and not to grant some sort of additional benefit to social clubs.⁷⁹

The Second Circuit's reasoning in *Brook* was that it was Congress's purpose to "[tailor] the deductions allowable to each type of organization according to the income to be taxed."⁸⁰ Therefore, since section 512(a)(1) organizations are taxed only on "trade or business" income, the allowable deductions under section 512(a)(1) are only those deductions "directly connected with the carrying on of that trade or business."⁸¹ In contrast, the income of a social club is taxed more broadly and a larger array of deductions are available, therefore the elimination of "trade or business" merely allows a section 512(a)(3)(A) organization to use section 162 or 212 or some other available deduction.⁸²

A second difficulty with the *Cleveland Athletic* court's economic gain test is that it is not consistent with the legislative history of section 512(a)(3)(A), which states:

75. For example, deductions incurred in obtaining interest income. This statement of legislative purpose is probably referring to the fact that a broader range of income is being taxed with regard to social clubs thus a broader range of deductions should be allowed. With regard to other tax exempt organizations, only trade or business income is taxed, thus only trade or business deductions are allowable.

76. See *infra* note 81 and accompanying text.

77. See *Brook, Inc. v. Commissioner*, 799 F.2d 833, 840 (2d Cir. 1986).

78. *Cleveland Athletic*, 779 F.2d at 1165.

79. See *Brook*, 799 F.2d at 840.

80. *Id.* at 841.

81. *Id.*

82. *Id.*

[T]he tax exemption [for social clubs] operates properly only when the sources of income of the organization are limited to receipts from the membership. Under such circumstances, the individual is in substantially the same position as if he had spent his income on pleasure or recreation . . . without the intervening separate organization.⁸³

It was the purpose of section 512(a)(3)(A) to allow individuals to join together for recreation or pleasure on a mutual basis without further tax consequences than if they acted on an individual basis.⁸⁴ However, it would clearly be contrary to legislative intent to allow social clubs greater advantages than other taxpayers merely because they chose to operate as a social club.

In allowing social clubs to deduct section 162 expenses without requiring a showing of profit motivation, the Sixth Circuit's view would result in precisely the preferential treatment sought to be avoided by the enactment of section 512(a)(3)(A). For example, if a taxpayer individually owns a horse and receives investment income, a profit motivation would have to be shown in order for excess deductions for maintenance of the horse to be allowable against the investment income.⁸⁵ Compare the above example with a riding club qualifying as a tax exempt social club which incurs some taxable income from nonmember riding fees. Under the *Cleveland Athletic* analysis, profit motive would not have to be shown for excess deductions to be allowable. Therefore, if the *Cleveland Athletic* standard is adopted, a taxpayer who chooses to operate as a tax exempt social club will have a significant advantage over a taxpayer who operates merely as an individual.⁸⁶

A third difficulty with the Sixth Circuit's economic gain test is the fact that section 512(a)(3)(A) explicitly requires deductions to be

83. S. REP. NO. 552, 91st Cong., 1st Sess. 71 (1969).

84. See *id.* at 71; H.R. REP. NO. 413, 91st Cong., 1st Sess., pt. 1, at 47 (1969).

85. This hypothetical would clearly fall within section 183 unless the taxpayer could show his ownership of the horse constituted a trade or business under section 162 which, in turn, requires a showing of profit motivation.

86. The *Brook* court noted that under the Sixth Circuit's reasoning, social clubs would be permitted to take deductions from a particular activity regardless of the amount of income generated by the underlying activity. *Brook*, 799 F.2d 833, 840. This is perhaps too broad a reading since the taxpayer in *Cleveland Athletic* was able to show gross income in excess of "direct costs" as defined by the Sixth Circuit. *Cleveland Athletic Club v. Commissioner*, 779 F.2d 1160, 1161 (6th Cir. 1985). Under *Cleveland Athletic*, the club would not have unbridled discretion as to pricing of services to nonmembers as suggested by the *Brook* opinion, but rather would have to show a basic purpose of economic gain. It is not clear from the language of *Cleveland Athletic* whether in all cases a social club would have to set prices sufficiently high to cover at least the direct costs of such services as defined in the opinion. However, the court's emphasis on the fact that the social club did satisfy this requirement suggests that the direct versus indirect costs analysis is a central factor in the Sixth Circuit's economic gain test. Nevertheless, the economic gain test would appear to allow social clubs to take a section 162 deduction for expenses incurred in activities not engaged in for profit which would result in giving social clubs a tax advantage not enjoyed by other taxpayers.

allowable under some provision of chapter one of the Code.⁸⁷ *Cleveland Athletic* does not directly address this issue, but appears to accept the argument advanced by the amicus curiae that the purpose of the "allowed by this chapter" language in section 512(a)(3)(A) is to require that deductions must satisfy the requirements of *some* provision of chapter one of the Code, not necessarily limited to section 162.⁸⁸ Without citing alternative authority for allowance, the court in *Cleveland Athletic* states that "the challenged deductions need not necessarily come within the [section] 162 trade or business allowance, but rather, the deductions are allowable as ordinary and necessary to the production of income *with a basic purpose of economic gain*."⁸⁹ Assuming that the Sixth Circuit meant to establish a new generic standard of deduction for all section 512(a)(3)(A) organizations, this new standard appears to be contradictory to the requirement that deductions be allowed by some provision of chapter one of the code.

The Sixth Circuit's economic gain test is not supported by the wording of the statute, legislative history, or the policies behind the enactment of section 512(a)(3)(A). Therefore, if it was the Sixth Circuit's intent to establish a new generic test which would supplant the profit motivation test of section 162, the Sixth Circuit's view ought to be rejected.

V. TAX PROFIT CONCEPT

The Tax Court in *North Ridge Country Club v. Commissioner*,⁹⁰ recently put forth an interesting twist on the approach taken by the Sixth Circuit in *Cleveland Athletic*. Although recently reversed on appeal, the Tax Court's approach in *North Ridge* is of continuing interest both because of its novelty and because it may be used in other circuits.⁹¹ The case involved a golf club qualified under section 501(c)(7) as a social club, which had extensive unrelated business activities generally categorized into three different areas.⁹² First, the

87. I.R.C. § 512(a)(3)(A) (1989).

88. *Cleveland Athletic*, 779 F.2d at 1164.

89. *Id.* at 1165 (emphasis added).

90. 89 T.C. 563 (1987), *rev'd*, 877 F.2d 750 (9th Cir. 1989).

91. Under the "Golsen rule," the Tax Court does not consider itself bound by one circuit if the case is appealable to another circuit. *Golsen v. Commissioner*, 54 T.C. 742 (1970), *aff'd. on other grounds*, 445 F.2d 985 (10th Cir.), *cert. denied*, 404 U.S. 940 (1971).

92. *North Ridge*, 89 T.C. at 565. The parties themselves originally stipulated to a different classification of activities which the Tax Court termed "misleading and contrary

club allowed its facilities to be used for a number of nonmember golf tournaments which were held on days when the facilities were closed to members.⁹³ The second general source of nonmember revenue was from food and beverage sales from nonmember banquets, other than those associated with tournaments.⁹⁴ These banquets occurred once or twice a month during the year and more often during the Christmas season.⁹⁵ Third, the club received substantial interest income.⁹⁶ In addition, the prices paid by nonmembers for the use of petitioner's facilities were substantially higher than those charged to members.⁹⁷

During the year at issue, the taxpayer incurred expenses which were characterized by the court as either "direct" or "indirect" expenses.⁹⁸ Direct expenses, which were directly proportional to the volume of a particular nonmember activity, were "traceable to the particular activity and would not have been incurred but for the activity."⁹⁹ "Indirect expenses" according to the court, were either fixed or "quasi-fixed."¹⁰⁰ In the category of fixed expenses, the court included property taxes and depreciation which were incurred whether or not the nonmember activity occurred.¹⁰¹ Among the "quasi-fixed" expenses, the court included utilities, general administration, and club house expenses which were subject to increase by nonmember activity but the increase was nominal or not easily allocable.¹⁰² Although the gross receipts from the nonmember activities exceeded the direct expenses, a net loss resulted when the indirect expenses were allocated to those nonmember activities.¹⁰³

The Tax Court held that the excess deductions from the nonmem-

to facts disclosed by the record as a whole." *Id.* at 571.

93. *Id.* at 566.

94. *Id.*

95. *Id.*

96. *Id.* at 564, 565.

97. *Id.* at 567. For example, in 1979, the cost of a mandatory golf cart for members and guests was \$9 or \$10, and the cost to tournament participants was \$10 or \$11. Although members were not charged greens fees per se, the greens fees charged to members for their guests was \$7.50 for 1979, while the charge to tournament participants was \$11. *Id.*

98. *Id.* at 565.

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.* The court cited, for example, utility expenses which were billed based on total usage. The court noted that it would be a "difficult if not impossible task to know how many kilowatt hours were attributable to each unrelated business activity." *Id.* at 565 n.5.

103. The parties stipulated with regard to revenues and expenses for 1979 as follows:

	Golf	Golf Carts	Food	Bar	Guest Fees
Revenue	13,170	11,819	39,281	43,406	1,015
Direct Expenses	8,820	3,975	43,389	28,389	-0-

ber tournament and banquet activities could be used to offset the interest income received by the club.¹⁰⁴ The court determined that both the banquet and tournament activities were entered into with the purpose of producing a profit.¹⁰⁵ In holding that a profit motivation existed, the Tax Court was able to distinguish *Brook* because the taxpayer in that case stipulated that a profit motive did not exist.¹⁰⁶

The *North Ridge* case is remarkable in that the Tax Court rejected taxable profit as the focus for determining profit motivation.¹⁰⁷ Instead, the Tax Court analyzed profit motivation from "the standpoint of an incremental increase in available funds to [the tax-

Indirect Expenses					
-Utilities	54	-0-	1,899	2,099	-0-
-Prop. Tax	36	-0-	1,259	1,392	-0-
-Depr.	352	2,023	3,461	3,824	-0-
-Gen. Adm.	2,004	1,798	5,977	6,605	154
-Club Hse.	627	563	1,870	2,066	48
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Total Expenses	11,893	8,359	57,855	44,211	202
	<u> </u>	<u> </u>	<u> </u>	<u> </u>	<u> </u>
Net Income	<u>1,277</u>	<u>3,460</u>	<u>(18,574)</u>	<u>(805)</u>	<u>813</u>

Id. at 565. The court recategorized the above figures in terms of the two general areas of nonmember golf tournaments and banquets. *Id.* at 572. After subtracting direct costs, the court determined that the following revenues were generated by the two activities:

Golf Tournaments:

Greens	\$4,350
Golf Carts	\$7,844
Guest Fees	\$1,015
Banquets (Food and Bar)	Unknown percentage of \$11,073*

Banquet:

Food and Bar	Unknown percentage of \$11,073
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* The Court was unable to allocate the food and bar revenues between those banquets associated with the golf tournaments and those standing alone.

Id.

104. *Id.* at 579.

105. *Id.* at 572.

106. *Id.* at 577.

107. *Id.* at 572.

payer].”¹⁰⁸ The court was not concerned with fixed costs such as depreciation and overhead which the taxpayer would incur whether the taxpayer conducted the activities in question.¹⁰⁹ Instead, the court measured “profit” by “each dollar earned over and above the *direct* costs of each activity.”¹¹⁰ Therefore, as the social club was receiving proceeds from each activity which exceeded the direct costs from such activity, the court held that a profit motivation existed.¹¹¹

In applying the profit motivation test to the activities in question, the Tax Court in *North Ridge* was implicitly applying Section 162, and not the economic gain test of *Cleveland Athletic*. However, the Tax Court’s application of the profit motive test of 162 was remarkably similar to the Sixth Circuit’s application of its economic gain test. In both *Cleveland Athletic* and *North Ridge*, the courts explicitly rejected tax profit as the measuring rod for allowing excess deductions from one activity to be used against another unrelated business activity.¹¹² Both cases drew a distinction between direct and indirect expenses, with the latter described as fixed expenses which would have been incurred whether the club participated in the relevant activity or not.¹¹³ In addition, in both cases income from the unrelated business activity exceeded direct expenses, but when indirect expenses such as depreciation, insurance, or administrative fees were added in, excess deductions resulted.¹¹⁴ Thus, the result under Sixth Circuit’s view is virtually identical to that of the Tax Court’s decision in *North Ridge*.

In contrast, the Second Circuit in *Brook*, never defined the nature of the “profit motive” test it applied. However, there are indications from the facts that “tax profit” was the determining factor. In its stipulation of facts, the taxpayer conceded that it “did not sell food and beverages to nonmembers with an intention that revenues from such sales would exceed all costs relating to such sales *including overhead*.”¹¹⁵ The *Brook* court concluded from this stipulation that the taxpayer agreed it did not intend to obtain a profit, which indi-

108. *Id.*

109. *Id.* This view is in direct opposition to the Service’s position in recent letter rulings. See, e.g., Tech. Adv. Mem. 85-08-004 (Nov. 16, 1984), wherein the Service stated that “when considering the factor of whether costs consistently exceed income [for purposes of profit motivation analysis], all costs should be taken into account, including such items as depreciation and overhead.” *Id.*

110. *North Ridge*, 89 T.C. at 572.

111. *Id.* at 573. This approach is virtually identical to the economic gain test of *Cleveland Athletic*. See *supra* note 49 and accompanying text.

112. See *Cleveland Athletic Club v. United States*, 779 F.2d 1160, 1165 (6th Cir. 1985); *North Ridge*, 89 T.C. at 572.

113. See *Cleveland Athletic*, 779 F.2d at 1161; *North Ridge*, 89 T.C. at 565.

114. See *Cleveland Athletic*, 779 F.2d at 1162 n.3; *North Ridge*, 89 T.C. at 565.

115. *Brook, Inc. v. Commissioner*, 799 F.2d 833, 835 (2d Cir. 1986) (emphasis added).

cates that the Second Circuit considers overhead relevant to the analysis of profit motive.¹¹⁶ Thus, presumably, even if the taxpayer in *Brook* was able to show it intended to charge nonmembers a sufficient amount to cover the direct expenses of providing the service, if the amount charged was not sufficient to cover overhead or other "fixed expenses," the Second Circuit would hold that the taxpayer did not have a sufficient profit motive to satisfy section 162.¹¹⁷

On hearing the *North Ridge* appeal, the Ninth Circuit adopted the *Brook* court's opinion and rejected the Tax Court's analysis of profit motivation.¹¹⁸ The Ninth Circuit held that a club "can properly deduct losses from a nonmember activity only if it undertakes that activity with the intent to profit, where profit means the production of gains in excess of all direct and indirect costs."¹¹⁹ Thus, the Ninth Circuit adopted the tax profit analysis criticized by both the Tax Court and the Sixth Circuit. As a rationale for its opinion, the Ninth Circuit cited essentially the same legislative history arguments which the *Brook* court used against the Sixth Circuit's economic benefit rule.¹²⁰

There is no clear case law support for the Ninth Circuit's view that the intention to realize a profit means intention to realize a tax profit.¹²¹ To the contrary, in *Leamy v. Commissioner*,¹²² it was held that "profit" for purposes of section 162 means "economic profit," independent of tax savings.¹²³ In analyzing whether tax profit is the

116. *Id.*

117. The facts of *Brook* were not sufficiently delineated to speculate as to whether the taxpayer charged a sufficient amount to cover direct expenses, or even whether the overhead expenses were of the same type of "fixed" expenses described by the courts in *Cleveland Athletic* and *North Ridge*. See *supra* notes 105-08 and accompanying text.

118. *North Ridge Country Club v. Commissioner*, 877 F.2d 750 (9th Cir. 1989).

119. *Id.* at 756 (emphasis added).

120. *Id.* at 752-54. The Ninth Circuit noted that the Tax Court's analysis of the profit motive test would allow certain income, such as investment income, to go untaxed. The court indicated that these revenues would be used toward the operation of the club, and felt that such a use of these untaxed revenues "is manifestly the sort of tax-free subsidy to social club members that section 512(a) sought to prevent." *Id.* at 756.

121. Some cases have appeared to use tax profit as a measuring stick. See, e.g., *Carter v. Commissioner*, 645 F.2d 784, 786 (9th Cir. 1981); *Lamont v. Commissioner*, 339 F.2d 377, 379 (2d Cir. 1964). However, those cases did not involve a situation where the activity to be measured was closely tied to a tax exempt activity. Further, in *Hirsch v. Commissioner*, 315 F.2d 731 (9th Cir. 1963), it was held that one test of carrying on a trade or business is that the taxpayer must have a "dominant hope and intent of realizing a profit, i.e. taxable income . . ." *Id.* at 736. However, as noted by the Ninth Circuit in *North Ridge*, 877 F.2d at 756 n.9, the *Hirsch* court was not presented with the problem of economic gain versus taxable profit, thus this statement is dicta.

122. 85 T.C. 798 (1985).

123. *Id.* at 808. In both *Cleveland Athletic* and *North Ridge*, the taxpayer re-

salient factor in determining profit motivation, it should be remembered that profit motive, for purposes of section 162, is not a statutory requirement.¹²⁴ Instead, it has been read into section 162 through numerous cases.¹²⁵

The profit motive test has generally been applied by reviewing all the relevant facts and circumstances of each case.¹²⁶ No one test is exclusive, and courts have applied a number of factors in determining if the taxpayer's activities were engaged in for profit.¹²⁷ Among the factors applied are:

- (1) [The] manner in which the taxpayer carries on the activity . . . (2) The expertise of the taxpayer or his advisors . . . (3) The time and effort expended by the taxpayer in carrying on the activity . . . (4) The expectation that assets used in activity may appreciate in value . . . (5) The success of the taxpayer in carrying on other similar or dissimilar activities . . . (6) The taxpayer's history of income or losses with respect to the activity . . . (7) The amount of occasional profits, if any, which are earned . . . (8) The financial status of the taxpayer . . . (9) Elements of personal pleasure or recreation.¹²⁸

The Ninth Circuit's approach fails to take into account these various traditional factors, and instead focuses solely on the expectation of a taxable profit. Assuming *arguendo* that taxable profit, rather than economic profit, is the proper standard, this single factor approach promises to be inflexible and unwise if applied outside the tax exempt social club context. For example, in the context of multiple businesses owned by a single taxpayer, taxable profit may not be the proper focus, or at least should not be the sole focus of the reviewing court.¹²⁹

ceived money which exceeded the direct costs of the service provided. See *supra* notes 105-08 and accompanying text. Therefore, using the *Leamy* approach, when the tax effects of allocable depreciation and utilities and other fixed costs are removed, arguably an economic profit results.

124. See generally I.R.C. § 162 (1989).

125. See *id.*; see also *Brannen v. Commissioner*, 722 F.2d 695, 704 (11th Cir.), *aff'd*, 722 F.2d 695 (1984); *Carter v. Commissioner*, 645 F.2d 784, 786 (9th Cir. 1981); *Lamont v. Commissioner*, 339 F.2d 377, 380 (2d Cir. 1964); *Adirondack League Club v. Commissioner*, 55 T.C. 796, 809 (1971), *aff'd*, 458 F.2d 506 (2d Cir. 1972).

126. See *Brannen*, 722 F.2d at 704.

127. *Id.*

128. Treas. Reg. § 1.183-2(b) (1989). Note that although section 183 technically does not apply until a determination is made that the requirements of section 162 are not met, courts have relied on these factors in analyzing profit motive under section 162. *Brannen*, 722 F.2d at 704; *Jasionowski v. Commissioner*, 66 T.C. 312, 319-21 (1976).

129. For example, consider two businesses operated by a single taxpayer where both businesses are operated out of the same facility. Assume one business is large and one small and the smaller business is tied very closely to the large business and is occupying space which would not otherwise be used by the larger business. Assume further that the smaller business would be entitled to a percentage of indirect expenses (as that term is defined by the Tax Court in *North Ridge*) which otherwise would be entirely allocable to the larger business. The allocation of the depreciation deduction might result in a net zero or negative taxable profit for the smaller business, even though the smaller business could expect a net positive economic profit. Thus, the use of a one factor tax profit stan-

The Ninth Circuit acknowledged that its definition of profit motivation in *North Ridge* is not intended to apply generally and is limited to the unrelated businesses of tax exempt social clubs.¹³⁰ It is the opinion of this writer that the profit motive test of section 162 ought to be applied consistently throughout the Code. To do otherwise would be to attempt to judicially legislate a modification in section 162 to meet the policy needs surrounding the tax exemption of social clubs. Thus, to the extent the *North Ridge* opinion suggests that the multifactor approach should not be applied to tax exempt social clubs, it frustrates uniform application. Therefore, the Ninth Circuit view ought not to be followed.¹³¹

Assuming the multifactor approach is applied in the social club context, there are a number of policy reasons favoring the Ninth Circuit's tax profit analysis over the Tax Court's economic profit analysis. By allowing a social club to utilize excess deductions for services provided to nonmembers against investment income so long as the prices for such services are above the expected direct costs as the economic profit analysis does, a social club could conceivably avoid paying any income tax at all. This is in direct contradiction to the legislative purpose of section 512(a)(3)(A) which was to tax such investment income.¹³² In addition, the Tax Court's version of the profit motive test could result in social clubs structuring their nonexempt activities to utilize investment income to subsidize the services to nonmembers.¹³³ As noted by the Second Circuit in *Brook*, such nonmembers are often friends of members, utilizing the services of the club at the invitation of a member.¹³⁴

Nevertheless, despite these reservations and policy considerations, the Tax Court's economic profit analysis continues to have vitality, at least in jurisdictions outside of the Ninth and Second Circuits. Although the Tax Court's view is inconsistent with the basic policies

dard could result in penalizing the taxpayer for operating the smaller business, even though the indirect expenses would have been entirely allowable from a profit motive standpoint had the smaller business not existed or had it operated in another facility.

130. *North Ridge Country Club v. Commissioner*, 877 F.2d 750, 756 (9th Cir. 1989).

131. It is conceivable that this type of case-by-case approach may result in inconsistent treatment, and that some social clubs might satisfy a multifactor analysis which does not test solely on taxable income.

132. TAX REFORM STUDIES, *supra* note 12, at 27.

133. The subsidizing aspect comes from the fact that deductions which would otherwise be usable against interest income (*i.e.*, depreciation on the club building, utility expenses) would become usable merely because the club provides some services to nonmembers.

134. *Brook, Inc. v. Commissioner*, 799 F.2d 833, 839 (2d Cir. 1986).

surrounding the taxation of unrelated businesses of section 501(c)(7) organizations, there is at least as much case law support for the Tax Court's economic profit factor as there is for the Ninth Circuit's tax profit factor.¹³⁵ Arguably the best solution to the continuing split of authority between the Sixth Circuit and the Second and Ninth Circuits would be for Congress to specifically delineate the conditions for deductibility of expenses of tax exempt social clubs.¹³⁶ Thus, this author recommends that Congress should enact legislation to modify section 512(a)(3)(A) to limit deductions attributable to nonmember services to income from such activities.

VI. CONCLUSION

The Sixth Circuit's economic gain test, if meant to be a replacement for section 162, is not supported by statute, case law, or legislative history, and ought to be rejected. In the alternative, *Cleveland Athletic* may be read to merely provide a gloss on section 162 in the context of section 512(a)(3)(A) organizations, whereby economic profit, rather than tax profit, is the focus of deductibility. This latter approach is similar to that taken by the Tax Court in *North Ridge* which may still have validity in other circuits despite its reversal in the Ninth Circuit.

While there is some case law support for this approach, several policy objectives weigh against its continued application. Under the *North Ridge* analysis, social clubs will be able to avoid taxation of investment income merely by structuring nonexempt activities to generate excess deductions which would not otherwise be allowable. Further, a social club would be able to use such nontaxed investment income to, in effect, subsidize nonmember services in direct contravention of the legislative purposes in enacting section 512(a)(3)(A).

Congress should revisit this area and either limit the amount of excess deductions a social club may use against investment income, or provide a clarified profit motive standard to be used with section 512(a)(3)(A) requiring the intention to realize a "tax profit" with regard to these activities.

135. See *supra* notes 119-21 and accompanying text.

136. Arguably, congressional action on this issue is preferable to a judicial solution since a final resolution of this issue by the Supreme Court or otherwise might cause more problems than are resolved. See *supra* notes 129-31 and accompanying text.